No. 11417

In the
United States
Circuit Court of Appeals
For the Ninth Circuit

Commissioner of Internal Revenue,
Petitioner,

vs.

National Reserve Insurance Company,
Respondent.

APPLICATION FOR LEAVE TO APPEAR AS AMICUS CURIAE
AND
BRIEF OF AMICUS CURIAE TENDERED WITH SUCH APPLICATION

ALLAN K. PERRY,
309 First National Bank Bldg.,
Phoenix, Arizona,
Applicant.

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APPLICATION FOR LEAVE TO APPEAR AS AMICUS CURIAE

To the Honorable, the United States Circuit Court of Appeals for the Ninth Circuit:

The application of Allan K. Perry, praying leave to appear as *amicus curiae* in the above numbered and entitled matter, respectfully represents and shows:

1. Applicant is a member of the bar of this court; his address is 309 First National Bank Building, Phoenix, Arizona, and he is counsel for National Union Insurance Company, Postal Benefit Insurance Company, and Empire Mutual Insurance Company (each of

whom is a benefit insurance company, organized and existing under the laws of the State of Arizona) the interests of each of whom may be affected directly or indirectly by the decision of this court in the matter here upon review.

2. As will be disclosed by the brief tendered herewith, applicant desires to urge before this court that the decision of the Tax Court of the United States (*6 T. C.* 473), now before this court for review, should be affirmed, and that the brief herewith tendered may be of assistance to the court in arriving at a correct determination of the questions presented by the parties to this proceeding.

WHEREFORE, applicant prays that he be permitted to appear herein as *amicus curiae* and file, for the consideration of the court, the brief tendered herewith.

Respectfully submitted,

ALLAN K. PERRY,
Applicant.

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BRIEF OF AMICUS CURIAE

I. SUMMARY OF ARGUMENT

1. The character of the business in which the taxpayer was engaged during the taxable years is determinative of its classification for income tax purposes.

2. Taxpayer was engaged in the life insurance business during the taxable years 1939 and 1940, within the meaning of the applicable sections of the Revenue Code.

3. It was never the intent of the Congress to tax the premium income of a life insurance company or any part thereof.

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II. ARGUMENT

1. The Character of the Business in Which the Taxpayer was Engaged During the Taxable Years Is Determinative of Its Classification for Income Tax Purposes.

In *Bowers v. Lawyers Mortgage Company,* 285 U. S. 182, 52 S. Ct. 350, 76 L. Ed. 690, the United States Supreme Court said:

> "While name, charter powers, and subjection to state insurance laws have significance as to the business which a corporation is authorized and intends to carry on, the character of the business actually done in the tax years determines whether it was taxable as an insurance company. United States v. Phellis, 257 U. S. 156, 168, 66 L. ed. 180, 182, 42 S. Ct. 63; Weiss v. Stearns, 265 U. S. 242, 254, 68 L. ed. 1001, 1005, 33 A. L. R. 520, 44 S. Ct. 490."

In *Commissioner v. W. H. Luquire Burial Ass'n,* 102 F. 2d 89, the Circuit Court of Appeals for the Fifth Circuit employed this language:

> "The authorities are almost unanimous in their holding that associations or companies of the character of this taxpayer are engaged in the life insurance business. Contracts such as the one issued by the Luquire Company are contracts of insurance and subject to control under the insurance statutes. 1 Couch on Insurance, Sec. 32; Benevolent Burial Ass'n v. Harrison, 181 Ga. 230, 181 S. E. 829; State v. Mutual Mortuary Ass'n, 166 Tenn. 260, 61 S. W. 2d 664; State v. DeWitt C.

Jones Co., 108 Fla. 613, 147 So. 230; South Georgia Funeral Homes v. Harrison, 182 Ga. 60, 184 S. E. 875; Fikes v. State, 87 Miss. 251, 39 So. 783; Renschler v. State ex rel., 90 Ohio St. 363, 107 N. E. 758, L. R. A. 1915D, 501, Ann. Cas. 1916C, 1014; State of Indiana v. Willett, 171 Ind. 296, 86 N. E. 68, 23 L. R. A., N. S., 197; Oklahoma Southwestern Burial Ass'n v. State, 135 Okl. 151, 274 P. 642, 63 A. L. R. 704; Annotation, 63 A. L. R. 723; Annotation, 100 A. L. R. 1453. See, also, State v. Brown Service Funeral Co., 236 Ala. 249, 182 So. 18."

In the instant matter, it seems to be conceded by both parties and found as a fact by the Tax Court that the respondent, during the taxable years here involved, operated under the *Arizona Benefit Corporation Law of 1937* (Sections 53-601, *et seq.* A. C. 1939) and that its business consisted of the issuance of policies of insurance upon the lives of its members.

It is submitted that the real test of the character of the business of the respondent is not the law under which it was incorporated, but the actual business transacted by it, under such law.

2. Taxpayer was Engaged in the Life Insurance Business During the Taxable Years 1939 and 1940, Within the Meaning of the Applicable Sections of the Revenue Code.

It is believed that a careful analysis of the Arizona statutes (Sections 53-601, *et seq.* A. C. 1939, set forth upon pages 39 to 44 of the petitioner's brief herein) will demonstrate that the "benefit corporations" oper-

ating thereunder are, in reality, mutual life insurance companies, without capital or surplus, but required to maintain, and who did maintain, mortuary reserves for the fulfillment of their policy obligations.

The Arizona Supreme Court in *Pioneer Mutual Benefit Association v. Arizona Corporation Commission,* 59 Ariz. 112, 123 P. 2d 828, has definitely determined that the creation and maintenance of policy reserves by companies operating under the *Benefit Insurance Law of 1937* is mandatory. In that case the court said:

> "A consideration of the Benefit Corporation Law of 1937, in its entirety, its nature and purpose, leads to the conclusion that the legislative intent was to impose upon all benefit corporations, organized under it, the duty of stating in each benefit certificate issued by it the proportion of each payment made therefore, periodic as well as original, that would be set aside to the mortuary and reserve fund. This appears clearly from section 53-606, subdivision (2), which makes this definite statement: '(a) Every benefit certificate issued by any such corporation shall specify the maximum amount not exceeding five thousand dollars ($5,000), on the life of any individual, to be paid on the happening of the contingency therein stated, *and shall state the basis or amount to be set aside to the mortuary and reserve fund.* . . .' (Italics ours.) The requirements that such a statement be incorporated in all benefit certificates automatically creates a mortuary or reserve fund, because the legislature certainly did not impose this duty on a benefit corporation and then per-

mit it to set aside the amount named to that fund provided it saw fit to do so. To say the legislature meant this would be to charge it with requiring a useless, futile act, one, in fact rendering it possible for a corporation organized under this law to mislead or deceive by making it appear to the purchaser of the certificate, and others who might read it, that a sufficient portion of the amount paid in by the purchaser would be set aside to pay benefit claims and general operating expenses as stipulated therein, when in fact it was merely discretionary with the corporation whether it did this. Other provisions of the Benefit Law of 1937, strengthen the view that it requires the creation of a mortuary and reserve fund. . . . While it is true all dues or premiums are paid in for the purpose, among others, of taking care of benefit claims later on, yet, unless a certain portion of them is set aside to a special fund for that purpose, for instance, a mortuary fund, it is very questionable that they would be exempt from attachment. This thought is suggested by section 53-605 which requires the corporation to deposit with the state treasurer $1,000 before the corporation commission may issue it a certificate to transact business, a sum that must be later increased to $10,000, yet under subdivision (d) of this section, reading as follows, this entire amount is subject to execution: '(d) Any unsettled final judgment of a court of this state shall be a lien on the deposits of money or securities prescribed by section 608b (Par. 53-605), and subject to execution after thirty (30) days from entry of final judgment. If said deposit is depleted thereby it shall be replenished within ninety (90)

days.' Section 53-610, A. C. A. 1939, provides as follows: 'At least once in every two (2) years the corporation commission shall require the books and the affairs of each benefit corporation to be examined and audited by an accountant designated and commissioned by it, for the purpose of verifying the funds as provided in the benefit certificate thereof. . . . ' There are but two funds provided for in the Benefit Corporation Law of 1937, one the deposit required to be made with the state treasurer just mentioned, and the other the mortuary and reserve fund. If a benefit corporation may or may not, at its option, create and maintain a mortuary and reserve fund, there would, in case it decided not to create and maintain such a fund, be but one fund, to-wit, the one deposited with the state treasurer, and in such instance there would be no 'funds as provided in the benefit certificate thereof,' to be verified by an examination.

"The word 'may' according to the authorities, is read 'shall' or 'must' when used in the statute to impose a duty, the performance of which involves the protection of public or private interests. . . .

"The legislature has, in the Benefit Corporation Law, imposed upon the corporation commission the duty of seeing to it that the premiums paid for benefit certificates (insurance policies) are sufficient to pay benefit claims. If in its judgment the premiums proposed in any certificate submitted to it for approval are not sufficient for this purpose, it would be its duty to refuse to authorize the corporation to solicit applications therefor, unless the corporation should not only

make the premiums sufficient for this purpose, but also state in the certificate what percentage thereof it is setting aside to the mortuary and reserve fund and it should appear to the commission that the amount set aside is high enough to take care of the benefit claims that might arise under it. If the commission should require a larger premium than necessary or that a greater proportion of those paid be set aside to the mortuary fund than the payment of benefit claims and general operating expenses would demand, the corporation could, in a proper action, have the commission lower it to the proper amount. But, as we see it, the legislature has placed in the jurisdiction of the corporation commission, a disinterested body to whose management the law has committed the insurance department of the state, complete power to see that benefit corporations, organized under the law of 1937, pay proper premiums and create out of them a mortuary and reserve fund large enough to take care of the benefit claims and general operating expenses arising thereunder."

Of course, the United States courts are bound by the interpretation of a state statute by the highest jurisdictional tribunal of the state.

Madden v. Commonwealth of Kentucky, 309 U. S. 83, 60 S. Ct. 406, 84 L. Ed. 590, 125 A. L. R. 1383;

Clarke v. Clarke, 178 U. S. 186, 26 S. Ct. 873, 44 L. Ed. 1028;

St. Louis Southwestern R. Co. v. Arkansas, 235 U. S. 350, 35 S. Ct. 99, 59 L. Ed. 265;

Storaasli v. Minnesota, 283 U. S. 57, 51 S. Ct. 354, 75 L. Ed. 839;

Webster v. Cooper, 55 U. S. 488, 14 How. 488, 14 L. Ed. 510;

Collins v. Streitz, (C. C. A. 9) 95 F. 2d 430;

Van Dyke v. Parker (C. C. A. 9) 83 F. 2d 35;

Collins v. City of Phoenix (C. C. A. 9) 26 F. 2d 753.

In *Reliance Benefit Association v. Commissioner,* 2 T. C. 15 (review dismissed, 143 F. 2d 597) the Tax Court said:

> "In discharging its duties under the Benefit Corporation Law of 1937 the state corporation commission required that reserves created by benefit corporations be calculated upon the basis of the American Experience Table of Mortality, with 3½ per cent accretions, or the approximate equivalent thereof. Consequently, it has approved the use of policies providing for reserves computed upon recognized mortality tables and assumed rates of interest, as well as policies providing for a reserve of at least 50 per cent of all premiums after the first year from date of issuance, if the premiums under the latter type of policies are sufficient that a reserve so computed will be substantially equivalent to one based upon accepted mortality tables. In order to determine whether the rates of premiums are sufficient for this purpose, the commission has referred all policies, prior to their approval, to an insurance actuary; and the commission has approved policies which, according to the actuary's report, proposed a reserve fund equivalent to one based upon the American

Experience Table of Mortality, with 3½ per cent accretions. . . .

"Since, in the instant case, petitioner was required by law to maintain a reserve equivalent to a reserve computed upon the American Experience Table of Mortality, with an assumed rate of interest, and since of its total reserves more than 50 per cent were held for the fulfillment of its life insurance policies, we hold that petitioner is a life insurance company within the meaning of section 201 (a) of the Revenue Acts of 1936 and 1938."

The Circuit Court of Appeals for the Fifth Circuit, in *Lamana-Panno-Fallo Industrial Ins. Co. v. Commissioner,* 127 F. 2d 56, discussed the question there presented as to whether the taxpayer was a "life insurance company" within the meaning of the 1936 Revenue Act and reached the following conclusion:

"We are of opinion that the Revenue Act, and Regulation 94 construing it, do not concern themselves with the sufficiency, but only with the character of the reserves of insurance companies. It is not the function of the Commissioner to review the decision of the State insurance department as to the sufficiency of the reserves or the solvency of the company. There is no federal policy to tax discriminatorily a life insurance company whose reserves may be deficient or depleted. Life insurance companies as a class are favored, particularly in Section 203 of the Act which allows a deduction from gross income of 'an amount equal to 4 per centum of the mean of *the reserve funds required by law* and held at the beginning and end

of the taxable year.' If the law, meaning the State law, requires assets to be tied up in a reserve for policies, this deduction of four per cent is allowed, probably, to offset a loss of interest by reason of the character of investment usually required for reserves. If the reserve required by the State is one hundred per cent of the full actuarial reserve, a greater deduction from gross income is obtainable than when only fifty per cent is required. The tax officer is bound to see that the deduction claimed is based on reserves 'required by law,' as contrasted with voluntary reserves sought to be used as a basis of deduction. He is also concerned to examine the reserves under Section 201 to be sure the taxpayer is a life insurance company at all, for that Section defines a life insurance company as one whose reserve funds held for the fulfillment of its life insurance and annuity contracts comprise more than 50 per centum of its total reserve funds. The company, if doing other business than life insurance and annuity, and setting up reserves for this other business, must have the major portion of its reserves held for its life insurance and annuity contracts, in order to be taxed as a life insurance company. The Regulation, Art. 201, very reasonably imports from Section 203 the qualification 'required by law', so that a voluntary increase in those reserves cannot be used to make into a life insurance company a company which otherwise would not be such. The Regulation in Art. 203(a)(2)-1 is careful to exclude all things from the reserve 'not required by express statutory provisions or by rules and regulations of the insurance

department of a State', and provides that 'a company is permitted to make use of the highest aggregate reserve called for by any State . . . in which it transacts business, but the reserve must have been actually held.' We find no provision in Statute or Regulation looking to a demand on the Commissioner's part for larger reserves that the State has required.

"The reserves here set up are required to exist by State statute, but the amount to be set apart is not expressly fixed. The statutes require the Secretary of State as Insurance Commissioner to be furnished annually the details of its business by each life insurance company, and that he cause the policies to be valued, and ascertain 'the reinsurance reverse' and 'surplus' on a stated actuarial basis, and no company can issue policies until it is found to have complied with the laws of the State and is given a certificate to that effect. Act 114 Louisiana Laws 1898. Other provisions touching reserves occur in Act 148 Louisiana Laws 1936, but there is no express requirement that one hundred per cent of the actuarial reserve be set apart. Yet the purpose to have the policies protected by a reserve is evident, and the 'surplus' of the company can be estimated only after ascertaining and deducting from assets full reserves. The laws certainly authorize the Secretary to require what he thinks are adequate reserves to be set apart, and an announced and enforced requirement on his part which is applicable to petitioner and all like insurance companies for the tax year establishes a 'reserve required by law' within the meaning of the Statute and Regulation. It ought to be so recognized.

> "We are asked to review and overrule our decision in Commissioner v. W. H. Luquire Burial Ass'n, 5 cir., 102 F. 2d 89, that contracts for burial benefits at death are a form of life insurance; since it appears that petitioner's insurance contracts were in an undisclosed amount of that sort. We are assured that the burial benefits contracts all had a cash measure of some sort, as they did in the Luquire case. We see no reason to doubt our former conclusion that they are a form of insurance against death."

But, if this *amicus curiae* correctly interprets the position of the Commissioner in the matter now at bar, it appears that he, the Commissioner, seek to distinguish the instant cause from the reported decisions upon the following grounds:

(a) The Arizona statutes permit and direct that a portion of the mortuary (reserve) fund be deposited with the State Treasurer and that a judgment against the company can be collected out of such deposit.

(b) Such statutes permit the use of the mortuary, or reserve, fund to pay attorney's fees and incidental expenses incurred in the defense of disputed claims.

(c) The "mortality savings" or the surplus in the mortuary fund over and above the reserves required by law could be, under the by-laws of the respondent, returned to the insured members in the form of dividends applied to the purchase of stock in a contemplated capital stock life insurance corporation.

If the Commissioner is correct in his contention (under the foregoing paragraph "c"), then it is submitted that every mutual life insurance company, from the oldest and strongest to the youngest and weakest, is forbidden *by the revenue statutes* from distributing its mortality savings in the form of dividends to its policyholders; and the entire amount originally collected for reserve purposes must be applied to the payment of policy claims exclusively, so that a reserve of several thousand per cent of that lawfully required for the fulfillment of life insurance contracts must be created or the company pay income tax on that portion of its premium receipts going into the creation of such reserves. It is submitted no such ridiculous and disastrous result was ever intended by the Congress.

Everything that the Commissioner says in his brief, with respect to the little items of attorney's fees, telephone tolls, etc., in connection with the settlement of claims, is ably answered by the majority Tax Court opinion in this cause, *6 T. C.* 473, thus:

> "Petitioner was a nonstock, nonprofit, mutual corporation and the savings or excess premiums in its mortality fund belonged to its policyholders, Its mortality reserve was not impaired by the pro rata distributions to policyholders. At all times material hereto this reserve was in excess of legal requirements. The incidental expenses charged to the mortality reserve were properly charged thereto under state law and petitioner's by-law XVI. The ledger entries with respect to incidental expenses specifically referred to the policyholder

whose claim was being settled and the expense items charged to the fund were incidental to settlement of the claims payable under the policies. *The aggregate amount in each year was not excessive and did not impair the reserve fund required by law to protect its policyholders.* The minor items were frankly admitted by petitioner to be an improper charge against the mortality fund. It is urged, however, that these items were nominal in amount, did not affect the sufficiency of petitioner's reserve, and show that the ledger account was not kept in accordance with good bookkeeping practices.

"Respondent argues strenuously that because of these charges the reserve funds held by petitioner were not true reserves as defined by section 201(a), since the reserve fund was subject to and was actually used to meet general operating expenses as well as policy claims. Respondent cites and relies upon First National Benefit Society v. Stuart (C. C. A., 9th Cir., 1943), 134 Fed. (2d) 438; certiorari denied, 320 U. S. 211; First National Benefit Society v. Stuart (D. C. 1944), unreported case, decided June 15, 1944, and section 19.203 (a) (2)-1 of Treasury Regulations 103. We do not understand that respondent denies the sufficiency in amount of petitioner's mortality reserve; his point is that, regardless of the amount set aside in the fund, it was not a reserve, since it could be and was invaded for ordinary operating expenses, and if a part of the fund is subject to such use the entire fund could be so used, which prevents the fund from being a 'reserve fund' within the meaning of section 201(a), supra.

"In considering the respondent's argument it must be remembered that general operating expenses were payable out of the expense fund provided for by section 2, article XVI, of petitioner's by-laws. His argument poses the question of whether the payment of minor items, which in no way impaired the reserve funds required for the protection of policyholders, and which were erroneously charged thereto, makes that reserve fund other than a reserve for benefit claims. We think not. To so hold would give book entries a probative weight to which such entries are not entitled, Doyle v. Mitchell Bros. Co., 247 U. S. 179. *Petitioner's assets available to satisfy policy claims and the mortality reserve exceeded mortality reserve requirements.* Bookkeeping errors or the use of this excess for business purposes should not defeat petitioner's classification as a life insurance company where it otherwise meets the requirements of section 201.

"Respondent argues that we should construe the term 'reserve funds' in section 201(a) the same as the Treasury regulations construe that term in section 203(a) (2) of the code. In Reliance Benefit Association, supra, we assumed that the term 'reserve funds' was to be given the same meaning in both sections. On that point, among other things, we said: 'The validity of such regulations (referring to the regulations on this point) has been recognized by this and other courts, Swift & Co. Employees Benefit Association, 47 B. T. A. 1011, and cases cited therein. . . . '

"But, while agreeing with the Commissioner in the Reliance Benefit Association case, supra, that

the term 'reserve funds' meant the same in both sections of the statute, we did not agree with him that the reserves there involved did not meet the test of the statute. We held that 'reserve funds' in that case, which were arrived at in all essential respects in the same way as in the instant case, qualified as true life insurance reserves within the purview of section 201 (a), and that the taxpayer there was taxable as a life insurance company. We so hold here." (Emphasis supplied.)

3. It was Never the Intent of the Congress to Tax the Premium Income of a Life Insurance Company or Any Part Thereof.

Prior to 1921, insurance companies had been taxed under the act of 1909 applying to corporations generally, but allowed a deduction of "the net addition if any required by law to be made within the year to reserve funds."

In 1921 a change was made in the general plan of taxation of insurance companies recognizing as a general principle that the collection of premiums for the purpose of paying expenses and losses is not true income but rather a contribution to capital. The special schedule for insurance companies under the Revenue Code provided for the taxation of life insurance companies *only on their investment income.*

The reasons for the change are set forth in *Helvering v. Oregon Mutual Life Insurance Company,* 311 U. S. 267, 85 L. Ed. 180, (affirming the decision of the

United States Circuit Court of Appeals for the Ninth Circuit, reported in 112 F. 2d 468) thus:

> "Legislative history discloses that a deduction similar to that allowed by 203 (a) first appeared in the Revenue Act of 1921. . . .
>
> "The new plan as it relates to Life Insurance Companies *had as its major objective the elimination of premium receipts from the field of taxable income.* It had long been pointed out to Congress that the receipts except as to a very minor proportion of each premium were not true income but were analogous to permanent capital investment." (Emphasis supplied.)

The entire reserves of the taxpayer in the cause at bar were certainly created out of premium income, and it is submitted the Congress never intended to tax such reserve accumulations.

Nor can the Commissioner, by any rule or regulation, convert a "life insurance company" into a "mutual insurance company other than life," when its entire business is that of insuring the lives of its members.

III. CONCLUSION

None of the benefit insurance companies regularly represented by this *amicus curiae* issues policies providing that the "mortality savings" may be used to create a fund for the establishment of a capital stock life insurance company. However, under the *1937 Benefit Corporation Act of Arizona* (which has now been superseded by *Chapter 95 of the Arizona Laws of*

1943, entitled "The Benefit Insurance Corporation Law of 1943"—Sections 61-919 et seq. A. C. supplement) all Arizona benefit corporations were authorized to, and probably did, use some small portion of their respective mortality funds in the defense of claims believed unjust or unwarranted. Also, under a strict interpretation of the act, the portion of the mortuary fund deposited with the State Treasurer was subject to use in payment of judgments obtained by general creditors, as well as judgments obtained upon a policy of insurance. So far as is known to the author of this brief, not one cent of any such deposit with the State Treasurer was ever used for the payment of any judgment of a general creditor against an Arizona benefit corporation.

But, it is submitted that even though portions of the mortuary fund were used in the payment of legal expenses or even in the payment of a judgment obtained by a general creditor if there still remained a reserve of over fifty per cent for the payment of policy claims, no one can successfully argue that the company (writing only life insurance) was thereby converted from a "life insurance company" to a "mutual insurance company other than life or marine" within the meaning of the Revenue Code.

Respectfully submitted,

ALLAN K. PERRY,
Amicus Curiae.